

DEPARTMENT OF STATE REVENUE

01-20190198.LOF

**Letter of Findings Number: 01-20190198
Adjusted Gross Income Tax
For Tax Year 2014**

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Individual could not substantiate the amount of research and expense credit taken by Individual's Company. The Department was correct in denying Company's research and expense credits resulting in additional income tax for Individual.

ISSUES

I. Adjusted Gross Income Tax—Research Credits.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-1; IC § 6-3.1-4-1; IC § 6-3.1-4-4; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dep't of Revenue v. Miller Brewing Co.*, 975 N.E.2d 800 (Ind. 2012); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); [45 IAC 3.1-1-66](#); [45 IAC 3.1-1-2](#); [45 IAC 3.1-1-7](#); [45 IAC 15-5-1](#); I.R.C. § 1366; I.R.C. § 41; Treas. Reg. § 1.41-4; Black's Law Dictionary (9th ed. 2009).

Taxpayer protests the disallowance of claimed research credits.

STATEMENT OF FACTS

Individual ("Taxpayer") is the sole shareholder for a transportation company ("Company"). Taxpayer employed a consulting firm to conduct a Research and Development Tax Credit Study ("Study") determining whether Company was eligible to claim certain Indiana research tax credits. Taxpayer's consultants ("Consultants") based their study on several items of information including statements made by the executives of the business, contracts, drawings, calculations, and employee's W2s. Taxpayer's research credit amounts were claimed based upon employee wage expenses only and no other costs were claimed. Taxpayer filed amended returns for the years 2009 through 2014 to reflect the results of the Study.

The Indiana Department of Revenue ("Department") conducted an audit for 2014. During the audit, the Department determined that Taxpayer failed to show that Company qualified for the research and development tax credit and to provide substantial contemporaneous documentation to show that the employees conducted "qualified research" thus, denying Taxpayer's claim for the Indiana research expense tax credit.

Taxpayer protests the Department's disallowance of the Indiana research and expense credit. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results. Additional facts will be provided as necessary.

I. Adjusted Gross Income Tax—Research Credits.

DISCUSSION

Indiana imposes an adjusted gross income tax on all residents. IC § 6-3-2-1. A taxpayer's Indiana income is determined by starting with its federal income and making certain adjustments. IC § 6-3-1-3.5. Income from an S corporation flows through to the individual shareholder's personal income and is reported by the shareholders on their personal income tax returns. See I.R.C. § 1366. See also [45 IAC 3.1-1-66](#); [45 IAC 3.1-1-2](#)(14); [45 IAC 3.1-1-7](#)(6). Simply stated, an S Corporation - such as Company - is "[a] corporation whose income is taxed through its

shareholders rather than through the corporation itself." Black's Law Dictionary 394 (9th ed. 2009). Pursuant to IC § 6-3-1-3.5, the Indiana income tax rules piggyback on the federal income tax statutes and regulations. Therefore, the federal rules and case law are generally applicable to determine an individual shareholder's tax liability. Any additional income received by the S-Corp as a profit passes through to the individual shareholders as income.

As a threshold issue, it is the taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. . . . The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

"[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to an agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Therefore, when the statute is plain and unambiguous there is no need to delve into the legislative history of the statute.

Our settled procedure of statutory construction begins with a determination as to **whether the legislature has spoken clearly and unambiguously on the point in question**. If so, our task is relatively simple: we need not "delve into legislative intent" but must give effect to "the plain and ordinary meaning of the language." *Indiana Dep't of Revenue v. Miller Brewing Co.*, 975 N.E.2d 800, 803 (Ind. 2012).

(**Emphasis added**) (Internal citation omitted).

Taxpayer filed an amended return for the year at issue claiming a tax credit. "An income tax [credit] is a matter of legislative grace and that the burden of clearly showing the right to the claimed [credit] is on the taxpayer." *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992). Moreover, where such a credit is claimed, "the party claiming the same must show a case, by sufficient evidence, which is clearly within the **exact letter of the law**." *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974) (**emphasis added**). Thus, Taxpayer's claims against any tax must be supported by records necessary to substantiate a claimed credit.

Taxpayer protests that the Department erred in denying the research and development tax credit for the year at issue. As stated above, Indiana follows the federal tax scheme with certain modifications. IC § 6-3-2-1(b); IC § 6-3-1-3.5(b). Indiana also provides certain tax credits which a taxpayer may claim to reduce its tax liability. See generally, IC § 6-3.1 and IC § 6-3.5. One of the tax credits available under Indiana tax law is the Indiana Qualified Research Expense Tax Credit under IC § 6-3.1-4-1 *et seq.* The 2003 statute, which was effective until December 31, 2015, and is relevant to the tax years at issue (the "2003 Indiana Statute"), provides:

The provisions of Section 41 of the Internal Revenue Code **as in effect on January 1, 2001, and the regulations promulgated in respect to those provisions and in effect on January 1, 2001**, are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period.

IC § 6-3.1-4-4 (2003) (**emphasis added**).

Further, "qualified research expense" under the 2003 Indiana Statute is "as defined in Section 41(b) of the Internal Revenue Code as **in effect on January 1, 2001**." IC § 6-3.1-4-1 (2003) (**emphasis added**). "Qualified research" is defined in the Internal Revenue Code ("IRC") under section 41(d). IRC subsection 41(d) defines qualified research in pertinent part as follows:

(d) Qualified research defined.-For purposes of this section-

(1) In general.-The term "qualified research" means research-

(A) with respect to which expenditures may be treated as expenses under section 174,

(B) which is undertaken for the purpose of discovering information-

(i) which is technological in nature, and-

(ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and

(C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3).

Such term does not include any activity described in paragraph (4).

I.R.C. § 41(d)(1).

However, before analyzing each part of the test, the audit consistently stated that Taxpayer could not provide sufficient documentation to substantiate its tax credit claim. Thus, this decision will first look to see if Taxpayer provided sufficient documentation to substantiate the amount of credit taken. The Department stated in the audit report, "The taxpayer has failed to accurately show documentation as to how wages were associated with each project. The taxpayer used and assumed percentage without documentation of time per employee per year. The taxpayer then divided that time by the number of projects the employee worked on that year. If an employee worked on three projects in a year, the taxpayer divided the employee's time evenly between the three [projects] regardless of actual time spent."

Taxpayer, in his protest, states that Indiana law does not require taxpayers to substantiate with documentation. Taxpayer cited to several Department's final determinations to support its claim that Taxpayer does not need to provide documentation. Upon inspection of those final determinations, actual documentation was either supplied at the time of the audit or protest for those taxpayers to substantiate their protest. In addition, Taxpayer states that "in absence of contemporaneous records the Department must issue an assessment based on whatever alternative means may be available." *citing*, LOF 04-20160661 p. 2 and LOF 02-20170109. Those final determinations refer to IC § 6-8.1-5-1(b); which provides, "If the [D]epartment reasonably believes that a person has not reported the proper amount of tax due, the [D]epartment **shall** make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the [D]epartment." (*Emphasis added*). See also [45 IAC 15-5-1](#). Thus, it is true that when the Department has determined that Taxpayer owes additional tax it must make an assessment based on "the best information available." In this instance, the Department did look at Taxpayer's "best information available" and determined that Taxpayer could not and did not substantiate the amount of credit taken. Therefore, based on the Department's "best information available", the Department issued an assessment based on "whatever alternative means may be available", which in this instance was by means of reducing Taxpayer's REC to zero.

It is the Department's position that even if Taxpayer could meet all four parts of the four part test, Taxpayer nonetheless failed to substantiate the cost under I.R.C. § 41. During the audit and protest process, Taxpayer could not link specific employees to specific portions of the claimed research and development activities. Further, Taxpayer could not accurately calculate how much time any employee spent on any portion of the claimed research and development. Under IC § 6-8.1-5-4 "Every person subject to a listed tax **must keep books and records** so that the department can determine the amount, if any, of the person's liability. . . ." (*Emphasis added*). In addition, Treas. Reg. § 1.41-4(d)(1) (2001) states that for taxpayer to receive the research and development tax credit, a taxpayer must:

Prepare[] documentation before or during the early stages of the research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of paragraph (a)(3) of this section and retains that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed [] for any year in which the taxpayer claims to have qualified research expenditures in connection with the research project; and (2) satisfies section 6001 and the regulations thereunder.

Thus, a taxpayer in Indiana claiming the research and development credit for the years January 1, 2003-December 31, 2015, must keep *contemporaneous* documentation. In this instance Taxpayer does not meet Indiana's standard under IC § 6-8.1-5-4. Taxpayer also did not meet the "contemporaneous documentation" threshold as described in the 2001 federal regulations. In addition, Taxpayer could not provide sufficient documentation to show the amount of time each claimed employee spent conducting the claimed activities. Therefore, Taxpayer did not meet the appropriate I.R.S. standard.

Taxpayer failed to substantiate the amount of credit taken, therefore his protest is denied. Since Taxpayer cannot substantiate the amount of credit, the Department will not discuss whether or not Taxpayer qualified for the REC. Thus based on the information above, Taxpayer has not met the burden of proving the proposed assessments wrong, as required by IC § 6-8.1-5-1(c).

FINDINGS

Taxpayer's protest is denied.

October 31, 2019

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